Notes on Coronacoma Economics

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The economic contraction we're experiencing is the fastest on record, by a large margin; we've probably lost as many jobs over the past two weeks as we did in the whole of the Great Recession. The policy response is also gigantic, several times as large a share of GDP as the Obama stimulus.

But it seems to me that we're still not having a very clear discussion of the economics of what's happening, why we're doing it, and what implications all this will have for the longer term, once the pandemic ends. So I've been trying to think it through in terms of a simple model — not even one involving any explicit equations, although I don't think that would be hard to do.

The main moral of this analysis is that what we should be doing — and to some extent what we are doing — is more like disaster relief than normal fiscal stimulus, although there's a stimulus element too. This relief can and should be debt-financed. There may be a slight hangover from this borrowing, but it shouldn't pose any major problems.

The nature of the problem

What we're experiencing is *not* a conventional recession brought on by a slump in aggregate demand. Instead, we're going into the economic equivalent of a medically induced coma, in which some brain functions are deliberately shut down to give the patient time to heal.

To simplify things, think of the economy as consisting of two sectors, nonessential services (N) that we can shut down to limit human interactions and hence the spread of the disease, and essential services (E) that we can't (or perhaps don't need to, because they don't involve personal interaction.) We can and should close down the N sector until some combination of growing immunity, widespread testing to quickly find and isolate cases, and, if we're very lucky, a vaccine let us return to normal life.

For those (like me) still receiving their regular paychecks, this period of shutdown — call it the coronacoma — will be annoying but not serious. I miss coffee shops and concerts, but can live without them for however long it takes.

Things will, however, be very different and dire for those who are deprived of their regular income while the coronacoma lasts. This group includes many workers and small businesses; it also includes state and local government, which are required to balance their budgets but are seeing revenues collapse and expenses soar.

How big is the N sector? Miguel Faria-e-Castro of the St. Louis Fed summarizes estimates that are as good as any: 27 to 67 million people, which he averages to 47 million. That's a lot; at a very rough estimate we might be looking at a temporary decline in real GDP of 30 percent or more. But that GDP decline isn't the problem, since it's a necessary counterpart of the social distancing we need to be doing.

The problem instead is how to limit the hardships facing those whose normal income has been cut off.

Disaster relief with a dash of stimulus

What can be done to help those cut off from their normal incomes during this period of national lockdown? They don't need jobs — we don't *want* them working at a time when normal work routines can spread a deadly disease. What they need, instead, is money. That is, what's needed now is disaster relief, not economic stimulus.

OK, a few qualifications. Some idled workers may be able to switch to doing other things at fairly short notice — say, Uber drivers making deliveries for Amazon. But that can't absorb more than a small fraction of the idled work force.

A more important point is that if we fail to provide enough help to those afflicted by this crisis, they will be forced to sharply cut their spending even on goods and services we can still produce, leading to a gratuitous further rise in unemployment (and a multiplier process as laid-off workers cut spending even more.) So aid to those in the shut-down sector actually does include an element of conventional fiscal stimulus, even though that's not its central goal.

Finally, the sudden shutdown of revenue streams for many businesses is creating financial stresses that resemble those of 2008-2009, with prices of risky assets plunging and investors trying to pile into government bonds. So the Fed is right to be going all out — doing "whatever it takes" — to stabilize financial markets.

In other words, there are pieces of this crisis that resemble conventional recession-fighting. But the core issue remains disaster relief for those hit hardest by the lockdown.

How do we pay for relief?

Where will the government get the money for the $2 trillion bill Congress has already passed, a bill that's much better than nothing but still far short of what we should be doing? The answer is, borrow. Real interest rates on federal borrowing are negative; the markets are basically begging the feds to take their money.

But why is borrowing so cheap? Where's the money coming from? The answer is private savings that have nowhere else to go. When we finally get data on what's happening now, we'll surely see a sharp rise in private saving, as people stop buying what they can't, and a fall in private investment, because who's going to build houses or office parks in a plague?

So the private sector is going to be running a huge financial surplus that's available for government borrowing. And this is no time to worry, even slightly, about the level of government debt.

Still, the pandemic will eventually end. Will there be a debt hangover?

From the point of view of government solvency, none at all. We live in a world in which interest rates are consistently below the growth rate, so that government debt melts instead of snowballing. The government won't have to pay back the money it's borrowing, just return to a sustainable level of deficits (*not* zero) and let the debt/GDP ratio decline over time.

There might, however, be a slight macroeconomic issue when the pandemic ends. The private sector will have added several trillion dollars to its wealth via more or less forced saving; between that wealth increase and, perhaps, pent-up demand, there might — might — be some inflationary overheating when things return to something like normal.

This may be a non-issue in an era of secular stagnation, when we might welcome the extra demand. Even if it is an issue, however, it's unlikely, given the numbers, to be something the Fed can't contain with modestly higher interest rates. You could imagine a world in which the costs of the immediate crisis eventually require some future fiscal austerity, but I don't think we're living in that world.

Let me summarize where we are. We're facing a period of unknown length when much of the economy can and should be shut down. The principal goal of policy during this period should not be to boost GDP, but to alleviate the hardship facing those deprived of their normal incomes. And the government can simply borrow the money it needs to do that.